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2015 Dealmakers Compendium

Privcap presents thought leadership from leading private equity investors

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About Privcap Media

Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communications services to market participants.

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Deals: the 'Darling Babies' of GPs

Although Privcap covers all aspects of the private capital universe—fundraising, performance, back office excellence—you won't be surprised at the number one topic private equity general partners want to talk about in our videos and reports

Deals are the darling babies of private equity GPs and receive the lion's share of attention and ego. And why not? It is through deals that the private equity firms win or lose. A deal expresses a firm's unique approach to generating wealth.

As such, Privcap features a steady stream of deal-related commentary from GPs "on the front lines" of the private equity market. The aim of this Dealmakers Compendium of thought leadership is to present some of Privcap's best commentary on this critical topic. We hope you are impressed with the people and content featured in this publication. We see these interviews as a valuable distillation of trends in the middle market. Indeed, over the course of my career as a journalist and editor covering the private equity industry, I've often told writers new to the beat that private equity is an excellent prism through which to learn about the world. Investors in the asset class are active in almost every economic sector and geographic region and at every stage of corporate growth, making bets on what the future will look like in the form of long-term investments.

It's fascinating to learn why a GP group is focused on a certain investment play as well as its unique format for realizing value. I hope that this compendium exemplifies the enthusiasm of the various GPs showcased here, as well as that of the Privcap editorial team for capturing and sharing these views.

All the best,

David Snow
CEO & Co-founder
Privcap
@SnowsNotes

Table of Contents

05 Inside Carlyle's Middle-Market Group
The firm's Rodney Cohen tells Privcap how Carlyle's subgroup for middle-market investments operates.

06 The Perils of Undifferentiated Deal Flow
Three experts discuss one of the main reasons an LP could turn down your next fund.

07 Eye on ESG
Michael Rogers of EY explains why private equity GPs are paying more attention to environmental, social, and governance issues when investing.

08 The Deal Whisperers
Heads of business development at three PE firms discuss their roles.

10 General Atlantic: Why We Backed Alibaba
The firm's Anton Levy details how its investment in China's Alibaba came about.

12 How GTCR's Leadership Strategy Built Devicor
Dean Mihas of GTCR tells the story of how the firm built up medical devices maker Devicor.

13 Data: PE and Healthcare

14 Plenty of Bright Spots in Healthcare
The Affordable Care Act has presented new opportunities to private equity, say experts from McGladrey's Transaction Advisory Services.

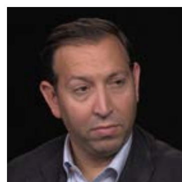
16 Z Capital's Unique Approach to Deal Sourcing
The firm's Jim Zenni explains how it sources high-quality companies that can benefit from operational or financial restructuring.

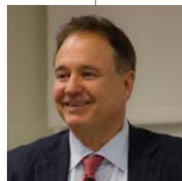
17 The Unwritten Rules of Midmarket Dealmaking
Middle-market deal flow has its own protocol, says Goodwin Procter's Jon Herzog.

18 Anatomy of a PE Deal
A look at how Arsenal Capital Partners came to invest in Chromaflo Technologies.

20 Drilling Down into Energy Partnerships
Leaders from shale development company PennEnergy Resources and its backer EnCap Investments talk about their partnership.

22 The Transformation of U.S. Energy Investing
ArcLight CEO Robb Turner explains why the U.S. energy market has changed for PE, and the country as a whole, since 2008.





23 Data: PE and Energy

24 Energy's Deal Standoff
As private equity firms and energy companies wait to see where oil prices land, deals are mostly in a holding pattern, says Grant Thornton's Sal Fira.

25 Does the World Need 700 New PE Firms?
Private equity has spawned an unprecedented number of new firms in recent years as investors have looked for strong returns.

26 The Mexico Opportunity
There are many reasons to invest in Mexico, say KKR's Vance Serchuk and Henry McVey. But this vast market should be viewed as a long-term investment play.

28 Western Canada Focus, Cross-border Opportunity
TriWest Capital Partners prefers to focus on companies that service oil and gas in Canada and across the border, says the firm's Cody Church.

30 Don't Embarrass The Lead Sponsor
LP co-investment experts from Cohesive Capital Partners and Neuberger Berman share tales from the trenches and tips on adding value.

32 Case Study: Mold Masters
Ken Hanau of 3i Group explains how his firm grew, and successfully exited, the maker of plastic injection molding components.

33 Company Valuations: Never an Exact Science
Valuation professionals use several methods and approaches to determine the value of a company, says Weaver's Brian Reed.

34 Leverage is Easy, Deals are Hard
Debt availability for private equity investments remains robust, but market experts are worried about finding quality deals.

36 Bain's Focus on Taking Businesses Global
Steve Pagliuca of Bain Capital discusses the company's global growth, and its investment in Canada Goose.

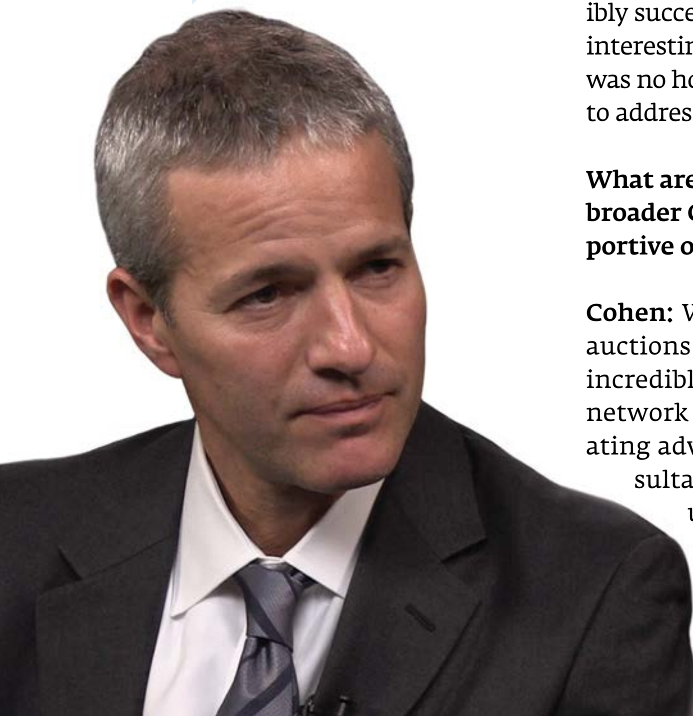
38 In Search Of High-Risk, High-Reward Execs
Recruiting an executive for a distressed portfolio company has a separate set of challenges, says the CEO of JM Search.

Inside Carlyle's Middle-Market Group

Managing director **Rodney Cohen** explains how the firm's subgroup for middle-market investments operates—and how it sources and wins deals

"We're using our network of CEOs, former CEOs, operating advisors, and industry consultants to source deals."

–Rodney Cohen, The Carlyle Group



Privcap: Carlyle has a dedicated middle-market group, which many people don't know about. What is the genesis of your team, and how do you define middle market?

Rodney Cohen, The Carlyle Group: Starting in about 2010, there was a recognition at the firm that, as our bigger buyout fund continued to get larger and larger, we were leaving what we call the middle market. The way we think about the middle market is writing equity checks under $200M. That's a big part of the market, and a market where Carlyle, historically, was incredibly successful. Lots of volume, lots of interesting opportunities, but there was no home within the firm dedicated to addressing that space.

What are some of the ways that the broader Carlyle organization is supportive of what your team does?

Cohen: We're trying to stay out of auctions today, because they are incredibly pricey. We're using our network of CEOs, former CEOs, operating advisors, and industry consultants to source deals. We're using industry resources that are affiliated with the firm and our portfolio companies to point us in the right directions—to trends and to things that are changing.

How do you try to be a successful investor in the middle market, which has become much more competitive?

Cohen: We try to stay out of competitive auctions. In today's market, with debt being as available as it is, and the pricing and the covenants that come with it, things tend to get bid up a bit higher, and people are stretching and pushing. There's lots of capital out there, and obviously it's a very efficient market. It's tough. When someone calls you and tells you that you won, you know it's because you're paying the highest prices. You have to pause and scratch your head a bit: "Did I win, or did I lose?" We try to find entrepreneurs, founders, owners, and we try to get to people and businesses before they're going to do a process.

What are some key themes that drive your investment sourcing?

Cohen: There are some areas that, historically, Carlyle is very strong in, and we're going to clearly gravitate to those industries. Aerospace and defense, industrials, transportation, and software service businesses are areas we have had success in. We try to develop a very diversified portfolio, and in a firm like ours there is so much expertise that we really are unlike other middle-market funds. We have such incredible depth of knowledge in so many different areas. ■

The Perils of Undifferentiated Deal Flow

Three experts discuss one of the main reasons LPs may turn down your next fund

Michael Elio, StepStone; **Mounir Guen,** MVision Private Equity Advisers; **William Chu,** Zurich Alternative Asset Management; **David Snow,**

Privcap: Let's talk about undifferentiated deal flow, where a GP fails to show how it is able to source and win transactions in a very competitive market.

William Chu, Zurich Alternative Asset Management: This is obviously a hot issue, particularly in the midmarket and the upper midmarket and to some degree the large-buyout segment. To be able to make a compelling case to show that you have historically, and continue to, generate deal flow in a way that few others can. In this highly competitive environment, it is a bit less proprietary.

How would a GP demonstrate an ability to win deals because of certain differentiating attributes within their team?

Michael Elio, StepStone: Every GP should probably understand that their story is not unique. You sit and you listen as an LP tells this story over and over again, GP after GP, that they don't realize they all sound the same. You have to make sure you understand from them—what makes you win a deal? Why did you skip a deal? In recent years, operational groups have been one of the marketing tools. GPs have said, "We won this because we have this great operational team that's going to add value post-close." Everyone now has an operation. You have to get into the meat of what the value is that you plan to add.

Mounir Guen, MVision: One key differentiator when we bring a GP to the market is: Who are you? The only way to identify you is to have you talk through your deals. We sit with the CEOs and CFOs, we listen to their story, and then we listen to the investment team in charge and take apart how they did this. I need to stress: Downloading 100,000 pages of data and saying, "Go have a revelation," is not a constructive exercise. They need to have a synopsis of "Here's why we do this," and then aggregate it. That is absolutely essential.

If you see evidence that most deals were won simply because they paid the highest price at an auction, would you hesitate to go forward with that GP?

Elio: What you buy it at isn't the end of the story. What you do with it afterward, if you get out of it at a good price—that all comes in. The days of LPs looking for good deal guys are gone. LPs are sophisticated enough to realize they're investing in a fund, not in a great deal guy. So if they can run their business and actually run a fund in a proper way to generate good returns, this all comes into deal flow. ■

Eye on **ESG**

Michael Rogers of EY explains why private equity GPs are paying more attention to environmental, social, and governance issues in their investments

A set of value-creation and value-protection considerations that began in the emerging markets are gradually making their way to the U.S. private equity sector, says Michael Rogers, the Private Equity Global Deputy Sector Leader at EY.

ESG, which stands for environmental, social and governance, refers to responsible investment standards that increasingly are being adopted by institutional investors—not only because they are good for the society, but because they can increase profitability and avoid unnecessary losses.

Private equity investors in the emerging markets were quick to initially focus on the "G" in ESG because governance is so often the missing ingredient for next-level success in developing economies. For example, the best private equity sponsors are well suited to help a family-run business develop a first-rate corporate governance structure to make the company more attractive to a strategic buyer or the public markets.

This governance focus has expanded to include the broader impact of a portfolio company. "As funds move into emerging markets, they figure that they have to go in and be good corporate citizens, treat employees correctly, and they are doing so with an eye toward making money," says Rogers.

Rogers gives the example of an Abraaj Group portfolio company, the Peruvian restaurant group Acurio Restaurantes, which, as it added new locations, made sure to double down on locally sourced ingredients, adopting an environmentally friendly waste management program, and opening a culinary school in a low-income area of Lima. The environmental and community-building features of this expansion have further endeared Acurio to the public, as well as to policymakers interested in how private equity firms do business. The deal is a "good example of how you can do well while you're doing good," says Rogers.

Carefully planning and broadcasting community engagement and corporate responsibility is increasingly becoming a focus for private equity firms in developed markets as well. Just as non-deal tasks like investor relations and compliance have risen to prominence within private equity firms, ESG and related functions are beginning an evolutionary process, starting in the largest private equity firms.

"Initially ESG was seen as an extraneous cost of doing business, especially in countries that have certain challenges," notes Rogers. "But in the next phase, GPs are seeing the benefits of ESG and then leading the charge. We know that some of the biggest funds are now viewing this as an opportunity, as opposed to a cost—a good business move.

"I hear my private equity clients say things like, 'We do the right things for the business, and more often than not those are the right things for communities, employees, and markets: training, providing benefits, community events. If we're doing the best at environmental perspectives, those are good business moves.'"■

Michael Rogers is a Private Equity Global Deputy Sector Leader at EY

EY Building a better working world

"Initially ESG was seen as an extraneous cost of doing business, especially in countries that have certain chal-

Andrew Bonanno is managing director of business development at Kohlberg & Co., a firm he has been with since 2009. He was previously a vice president of business development for the New York–based buyouts team of American Capital and has also worked for GE Equity. He received degrees from Connecticut College and Washington University.

Lex Leeming is a principal and head of business development at Moelis Capital Partners. Previously he was a principal with middle-market buyout fund Park Avenue Equity Partners and worked in strategy and marketing at American Express. Leeming received degrees from Tufts University and the Kellogg School of Management at Northwestern University.

Luke Johnson is senior managing director and head of business development for Sentinel Capital Partners. He previously spent 12 years at Platinum Equity, most recently as a principal and global head of business development, and was also a director at Kroll Associates. He received degrees from Pepperdine University and the University of California Los Angeles.

The Deal Whisperers

Some PE firms have upped the ante on deal sourcing by adding a head of business development to foster relationships. Three of these professionals from Kohlberg & Co., Moelis Capital, and Sentinel Capital discuss their roles and the importance of differentiation of firms.

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Business Development Trend Grows

In the past 10 years, more private equity firms have added the role of head of business development as they try to bolster deal sourcing efforts.

"At its simplest level, we're in charge of sourcing investment opportunities," says Lex Leeming, principal and head of business development at Moelis Capital Partners. "But really, the role comprises the opportunity to be sort of an ambassador for the firm."

The role also encompasses relationship management and trying to identify deal flow, along with making sure the firm is relevant to the intermediary universe.

"I look at my role as sort of architecting and playing air traffic control…in terms of all of the third-party intermediary relationships out there, which are flowing us deals on a regular basis," says Luke Johnson, senior managing director and head of business development for Sentinel Capital Partners.

While the position is effectively a sales force for firms, with relationship management thrown in, Andrew Bonanno of Kohlberg & Co. says they view it differently.

"I work with our operating partners and a deal partner to develop a thesis around a subsector within the five industries that we cover, and then try to proactively originate opportunities that are intermediated or proprietary," Bonanno says.

Differentiation Is Key

With so many middle-market private equity firms, it's important for intermediaries to see unique capabilities—something different or special.

"Being able to differentiate yourself in what is now a very efficient, very transparent market is absolutely critical," Leeming says. "There's so much money coming into the asset class. There's so much money chasing very few really attractive deals."

The track record for partnering with management teams is the differentiator that Sentinel Capital tries to impress on prospective targets.

> **"Being able to differentiate yourself in what is now a very efficient, very transparent market is absolutely critical. There's so much money coming into the asset class."**
>
> –Lex Leeming, Moelis Capital Partners

> **"I work with our operating partners and a deal partner to develop a thesis around a subsector within the five industries that we cover, and then try to proactively originate opportunities that are intermediated or proprietary."**
>
> –Andrew Bonanno, Kohlberg & Co.

"In those situations, a lot of the time, we're bringing more than just that capital to bear," says Johnson. "We're bringing our operational expertise, our ability to put in place the right systems and processes to help scale companies."

Bonanno says that Kohlberg goes through a process of writing proprietary white papers to "elevate the IQ of the partnership…develop our angle, and then, when we go out and speak with specific industry bankers, we say, 'This is what we're looking for.'"

In the end, the business development professionals at a PE firm are not there to take the place of deal partners but to complement them and manage relationships.

"We're responsible for institutionalizing those relationships and making sure that this air traffic control, the right and left hand, are communicating the coordinated," Johnson says.

Deal Sourcing Style Matters

As the PE deal market has become more transparent and efficient, limited partners have started caring more about how a general partner sources its deals.

If you have a fantastic fund, "LPs want to know that you have the mechanisms in place to re-create that deal flow," says Moelis Capital's Leeming, "that it's not just a one-hit wonder."

While there may be a perception among LPs that proprietary deals exist, that isn't necessarily the case.

"I personally have never seen a proprietary deal, and I've been doing this for 14 years," says Sentinel's Johnson. "In such a competitive environment today, a seller really has a fiduciary responsibility to at least talk to two people."

Tapping into connections from college or elsewhere may no longer work to source deals.

Kohlberg's Bonanno says that he thinks about his business as 80 percent of the deal flow coming through intermediated channels, with the other 20 percent coming from the firm's white-paper initiative. "I believe that leads to a lot more of these one-off conversations, limited processes, and as we've tracked it, we're seeing results," he says.

Traveling the country talking to bankers, visiting conferences and trade shows, helps Johnson develop intelligence and information that he uses to create a thesis and drive some deal opportunities as a result.

"Not only are we the ambassador externally, selling our firms and our value propositions," Johnson says, "but it's incumbent upon us to also sell internally to our deal partners." ■

GENERAL ATLANTIC: Why We Backed Alibaba

Following the largest IPO in history, Alibaba PE backer General Atlantic is reportedly seeing a roughly 18x increase in the value of its $75M investment in 2009. GA's Anton Levy speaks with Privcap about the deal—one of the most successful in the firm's history.

"It's been an honor to be involved with Jack [Ma], Joe [Tsai], and the rest of the management team. It's been one of the top two or three investments in our 35-year history."

–Anton Levy, General Atlantic

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Privcap: Where does Alibaba rank in the history of General Atlantic as far as magnitude of success?

Anton Levy, General Atlantic: It's been a big success, and it's been an honor to be involved with Jack [Ma], Joe [Tsai], and the rest of the management team. It's been one of the top two or three investments in our 35-year history.

How did General Atlantic become involved with Alibaba?

Levy: Back in early 2008, Jack and Joe were looking to see if they could help monetize some of the Yahoo! position that ultimately consummated itself later in 2011. We met them through that process and began to develop a relationship. Every couple of years, they bring the top 15 to 20 business leaders across their entire organization to the U.S. They asked if we would be willing to sit down with them and talk about what we've done to build a successful investment organization. The next day, they reached out to me and said, "We think you have an interesting culture, approach to business, to partnerships, and to how you work with entrepreneurs." And they said they would love to find a way for us to become shareholders of Alibaba Group.

What was your impression of Jack Ma and Joe Tsai during the early period of your relationship?

Levy: They're incredibly complementary to each other. Jack is really the consummate entrepreneur and visionary. When we met him, he was talking about his 100-year plan. And a lot of us chuckle when we hear 100-year plans. We're trying to figure out what we're doing over the next two to three years. He's a charismatic leader in terms of recruiting, and he's complemented by Joe Tsai, who is one of the best business leaders around. He's underappreciated because he has such a low profile and such [little] ego. But Joe runs big chunks of that business and has for many years.

What did you like about Alibaba's business in 2009, when you made the investment?

Levy: The truth is, liquidity is really hard to get in the marketplace. The size and scale of the liquidity they had is what brought us in. They've been able to monetize it for years, but the opportunity to generate the liquidity, plus their team, is what initially got us incredibly excited. We had also spent a lot of time looking at Chinese e-commerce, and we were looking for a long-term opportunity in Chinese e-commerce. We did not sell in the IPO, and our view is that the business is going to be multiples the size of its current state over the coming years.

> **"Liquidity is really hard to get in the marketplace. The size and scale of the liquidity they had is what brought us in."**
>
> —Anton Levy, General Atlantic

We think that the growth's going to come across a whole bunch of different lines of business. We think they're relatively early in the monetization of their user base. They're already 80 percent of all mobile e-commerce in China, and when we made our investment they had 70 percent of the Chinese e-commerce market. Alibaba is now over 100 percent of the entire profitability of the of Chinese e-commerce sector.

What kind of strategic guidance did you bring to the Alibaba team during this period of investment?

Levy: All discussions are two-way, but I would say most of the dialogue was largely at the strategic level, on acquisitions and investments they were going to make.

When people ask how General Atlantic got into Alibaba, what is your response?

Levy: It's because of our reputation and what we can do for them. We've spent years trying to manage and earn our reputation, and we don't often raise our hands and wave our own brand. It's much more about the teams that we back. You want to choose a partner that can change outcomes for you, and many of our CEOs would attest that we've changed outcomes for the positive for them. And the last piece is, because of all this, we're in a small-network world. Just like we're doing due diligence on firms like Alibaba, they're doing due diligence right back on us. More than anything, we've been great partners of management teams and have changed outcomes. And that, as a result, allows us the opportunity to invest in some of these companies and partner with these great teams. ■

GTCR's 'Leaders Strategy' Works Out for Devicor

Managing director **Dean Mihas** tells how GTCR backed a management team and built medical-devices business Devicor before ultimately exiting the company

Privcap: You invest in healthcare companies on behalf of GTCR, and you recently exited a big platform company that GTCR built up called Devicor Medical Products. How did that deal come about, and what did you do to improve its fortunes?

Dean Mihas, GTCR: Devicor is a medical-products company based in Cincinnati. Its main product is a system that performs a breast biopsy. The situation is, a woman has a mammogram, and there's some abnormality that the physician wants to extract and test for cancer. We have a system where the woman would go in for an outpatient procedure and get that lesion removed via biopsy. The company sells directly into 10 countries and distributes to another 40 countries.

Your firm is known for taking a management-first approach. Why does that work?

Mihas: We call it "the Leaders Strategy," and it's been the same strategy the firm has pursued since its founding in 1980. Our investment process all starts with identifying a high-quality management partner who we want to work with, in combination with developing a thesis in a particular area of the industries we cover. Devicor is a great example of this strategy. We developed a thesis, and we went out and met a number of executives who have led companies in and around the interventional product space. We met Tom Dalton, who became CEO of Devicor. We partnered with Tom in advance of having any company or assets.

How did you make Devicor attractive for a sale to a strategic buyer?

Mihas: First, we proactively approached a number of companies. Johnson & Johnson was one of the companies we approached. They had a product line we were familiar with and that fit our thesis. We were able to negotiate a deal with J&J, which took about 12 months to complete.

It was a business that didn't really fit inside J&J. We had a vision that we could pull this product set out—the biopsy system and a couple of other related products that they sold with the system—and create a stand-alone company out of it.

The carve-out process from J&J required us to set up an entire back-office infrastructure. We had to move our manufacturing out of the J&J facility. We set up new manufacturing facilities within 18 months after closing the transaction. Then we had to get regulatory approval in each of the countries that we distributed or sold the product to directly. That took anywhere from a year to three years. In addition to that, we completed four small acquisitions of products related to the products we were selling, and two licensing deals, also of products that were related. All those things in totality effectively created a very different business from the one we started with and created a stand-alone company that became an attractive strategic asset for a number of larger med-tech companies. Ultimately, Danaher has a business called Leica [Biosystems] that acquired Devicor. ■

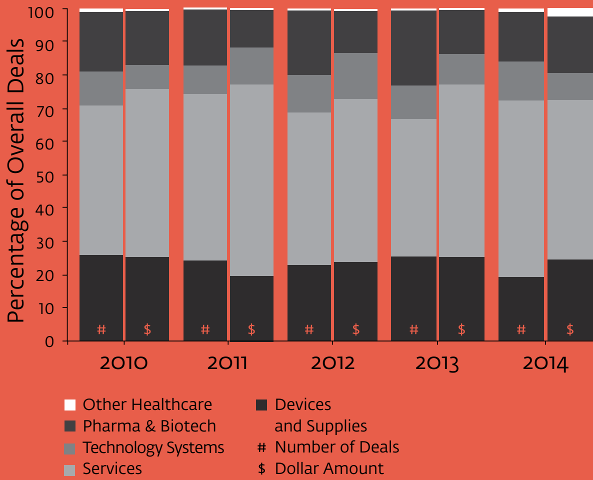
"Our process starts with identifying a high-quality management partner, in combination with developing a thesis in a particular area of the industries we cover."

— Dean Mihas, GTCR

DATA

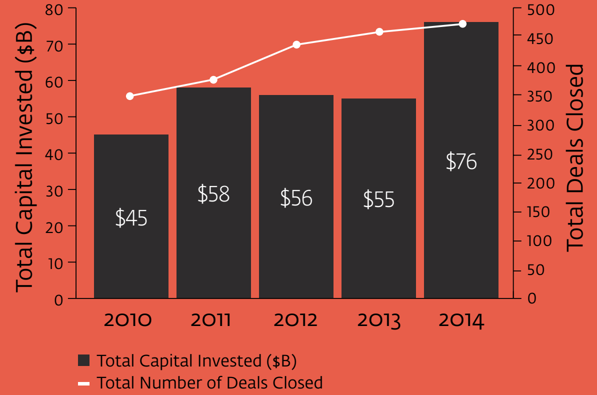
Uptick in Number of PE-backed Services, Tech Systems Deals

Healthcare services and tech systems subsectors took a larger number of deals in 2014, with devices and supplies, and pharma and biotech declining. By dollar amount, tech systems and services deals shrank in 2014. The winners: pharma and biotech, and "other healthcare."



U.S. PE-backed Healthcare Deals Increase

Overall, the number and dollar amount of PE-backed health-care deals in the U.S. remained somewhat steady for three years, but saw a more than $20B increase in 2014.



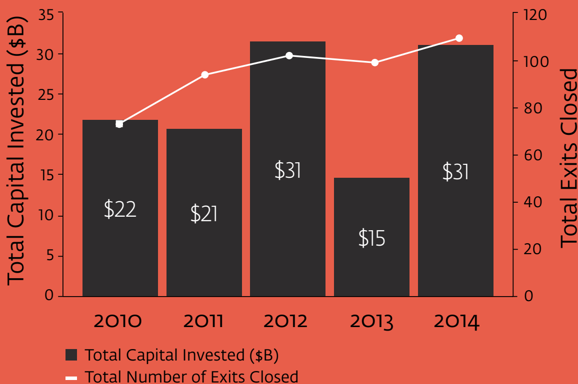
DEALS

Private Equity's Role in U.S. Healthcare Deals

The Affordable Care Act and M&A of healthcare businesses have led to a rise in deals. Meanwhile, the dollar amount of exits from healthcare companies by PE firms more than doubled between 2013 and 2014.

Choppy Market for Healthcare Exits

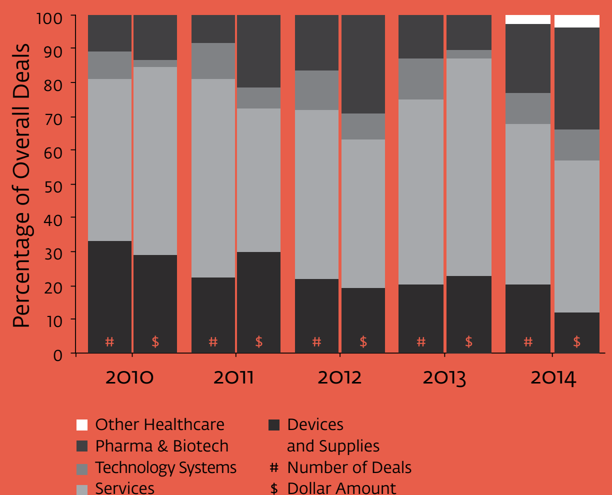
The total amount of capital exited from healthcare companies by PE took a nosedive in 2013, but made a resurgence in 2014.



EXITS

PE-backed Pharma and Biotech Exits Rise

The number of PE exits by subsector has stayed mostly constant since 2010, but pharma and biotech rose in 2014, as did "other healthcare." By dollar amount, exits from those two sectors, as well as technology systems, rose, while devices and supplies, and services, declined.



Source of all charts: PitchBook

Plenty of Bright Spots in Healthcare

The Affordable Care Act has expanded the pool of potential healthcare customers, translating into an opportunity for private equity transactions, says a trio from McGladrey's Transaction Advisory Services

As more Americans sign up for health insurance as part of the Affordable Care Act, the healthcare sector becomes increasingly attractive to private equity buyers.

This means that an uptick in mergers and acquisitions in healthcare companies is on tap for 2015 and beyond, with some subsectors becoming particularly attractive, say experts from McGladrey in a recent healthcare report.

"One of the things you hear private equity people talk about, as well as those in healthcare, is, as the ACA has expanded coverage, you have a broad sector with a larger pool of potential customers," says Tammy Hill, a partner in Transaction Advisory Services at McGladrey. "That doesn't happen much in many industries."

The most attractive sectors for M&A at the moment provide alternatives to traditional medical care and include urgent-care clinics and telemedicine, Hill adds, which are more cost-effective and less expensive than visiting a hospital or physician.

Overall, the M&A market is a "very competitive, frothy environment," says Andy Jenkins, a partner in Transaction Advisory Services at McGladrey. Prices are high, and there is a favorable lending environment, so PE is also hungry to make investments.

"You see a fragmented healthcare industry," says Jenkins. "It's ripe for roll-up [transactions]."

Strategic companies are sitting on a lot of cash and bidding deals up, but private equity is also sitting on dry powder, looking for a growth sector.

Ron Ellis, McGladrey's director of Transaction Advisory Services, says another area of growth outside of the ACA is baby boomers who are creating new needs in the healthcare sector related to an aging population. Services including physical therapy, pain treatment, dermatology, ambulatory surgery, personal-emergency response, and home health are among the hot healthcare subsectors

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Ron Ellis, McGladrey

Tammy Hill, McGladrey

Andy Jenkins, McGladrey

"A lot of sectors tie to aging populations," Ellis says. "That's why we're seeing more healthcare deals getting done."

Another subsector that private equity has its eye on is behavioral health, also because of the ACA providing more people with coverage. Hill says that at a recent conference co-sponsored by McGladrey, attendees spoke about "a significant shortage of capacity compared to need" owing to expanded coverage.

While private equity is rushing toward healthcare-related transactions, there are subsectors to be avoided, Ellis says—namely, hospitals and pharmaceuticals. "Hospitals are buying hospitals, and on pharma, the transactions are just too big."

In general, private equity is avoiding investments tied to third-party reimbursement, especially Medicaid and Medicare. The heavy percentage of revenues derived from them involves too much risk for investments by the asset class.

Add-on M&A transactions are growing in popularity in areas where consolidation makes sense, such as healthcare systems looking to expand their continuum of care with post-acute-care rehabilitation, skilled nursing, and home health, says Hill. On the private equity side, one exit alternative for such a portfolio company is to sell to a strategic buyer like a healthcare system.

"One of the things you hear private equity people talk about, as well as those in healthcare, is, as the ACA has expanded coverage, you have a broad sector with a larger pool of potential customers."

—Tammy Hill, McGladrey

"A lot of sectors tie to aging populations. That's why we're seeing more healthcare deals getting done."

—Ron Ellis, McGladrey

"You see a fragmented healthcare industry. It's ripe for roll-up [transactions]."

—Andy Jenkins, McGladrey

The trajectory of growth for healthcare transactions is expected to continue, not only in those areas affected by the ACA but also in information technology and software development.

"If interest rates are this low and there's all this money sitting unspent, healthcare is going to be in the top two to three industries" for investment, says Ellis.

There are areas for concern, including how the federally funded expansion of Medicaid will be paid for by states in the long term once federal money is no longer on the table. "That's going to be the ugly part of all of this in the next few years," Ellis says.

Hill adds that private equity players would admit concern that the market for healthcare deals is "going to become overheated with the multiples we're seeing. I've heard comments that you can't really assume that five to six years from now, the multiples will be at those levels or higher."

Despite these concerns, there is overall optimism about opportunities for private equity to invest in the healthcare sector. And the attitude about the Affordable Care Act from those in private equity has shifted, says Jenkins. "A couple of years ago, when the law was coming out, there was a lot of uncertainty and hesitation from investors. You don't see that hesitation today."■

How Z Capital Finds Deep Value

The firm's president and CEO, Jim Zenni, explains how it sources high-quality companies that can benefit from operational or financial restructuring

"What really drives us is finding businesses that have a real purpose, real market share, real product development, and real cash flow."

Jim Zenni, Z Capital Partners

Privcap: Your firm is well-known for being a value investor. How do you define value in the context of private equity investing?

Jim Zenni, Z Capital Partners: We try to find high-quality companies that have some operational or financial issues but are still very good businesses. However, through operational or financial restructuring, these companies could be much better. What really drives us as far as value is finding great businesses that have a real purpose with real market share, real product development, and real cash flow.

How do you source deals?

Zenni: We have the ability to identify companies within certain industries and [of] a certain size that are potentials for an ownership change, a restructuring, or an operational turnaround. We have people calling on commercial banks and other counterparties to be proactive in our sourcing activities. Most of the activity that we pursue, we do it directly.

How is the way you approach due diligence distinct from the way a private equity firm would typically conduct it?

Zenni: Our due diligence process is lengthy, and we like doing it exclusively with counterparties. When I say lengthy—it's completed by both the financial investment part of our team, as well as the operational team, and in many cases will take months.

What are some of the important factors in the market right now that are affecting both your ability to source new opportunities and the fortunes of the portfolio companies you already own?

Zenni: If you look at the common themes today, you've got forgiving credit markets, meaning there's no financial covenants in many of these transactions. In the senior debt, the maturities are very long, so it gives the owner of those companies a lot of latitude on timeline.

Then you have the overlay, currently, of commodity prices, specifically oil prices, which have a fairly large ripple effect. I'm not sure the marketplace at large has really sorted out what the end result of that's going to be, but you're going to see default rates rise. In our particular case, it's going to be more of the secondary companies that support some of the oil-related companies.

By definition, all of the companies you invest in have some form of operational challenge that has put them at a disadvantage. What are the most important steps you take to help map out a path to improvement for these companies?

Zenni: At the outset, while we're doing the due diligence, we identify a group of items that we'll address. In many cases, the balance sheet needs to be resized. And there are always operational items that we can address, depending on the industry and on the type of company. That gets mapped out very early on in the due-diligence process.

Then we attack an acquisition with five or six people daily for many months—executing on the plan we've developed on the front end. ■

The Unwritten Rules of Midmarket Dealmaking

A veteran of midsized deals says his market is populated with bright people and unwritten protocols

Nimble is a word that best describes Jon Herzog, a partner in Goodwin Procter's Private Equity Group.

"We are laser-focused on the middle market, and for us this includes most forms of growth equity deals," he says. "You have to be flexible in this space, because there are so many types of deals. Investors and entrepreneurs often do minority deals. In many cases, these deals involve liquidity or leverage, and often substantial, profitable companies. On the other side of what is a broad spectrum, you will see very large and complex leveraged buyouts from any of a range of sellers-existing private equity sponsors, founders, or larger companies looking to divest a division."

Herzog says that these deals have several things in common. Personal relationships are very important. In the middle market, the parties to the transaction are the owners of the assets involved; they are smart, they are entrepreneurial, they are practical and direct, and they come from all regions of the country and the world. You need to know how to relate to these principals and help make the relationship between the entrepreneurs and the investors work.

It is also critical to know what is "market" in these deals. There is a set of principles that generally applies in midmarket deals, for M&A, debt financing, rollovers, and management incentive equity. Because middle-market players come from so many different backgrounds, and because the space combines both minority and majority deals, it is important to know where the issues, or the "rules," usually come out and how they shift as market conditions change.

Goodwin's Private Equity Group operates across a broad range of middle-market deals on any given day. With a full-service team of more than 100 lawyers, the practice covers the full life cycle of middle-market clients' investments across industries including technology, life sciences, FinTech, financial services, consumer, healthcare, and food-from fund formation to exit.

"The rules and norms of middle-market dealmaking aren't published anywhere–you simply have to be a practitioner to interpret and effectively use them on behalf of your clients," says Herzog. "These rules involve a combination of market knowledge and often a particular style that is hard to articulate but, at a minimum, is the opposite of what I call an arrogant, scorched-earth style."

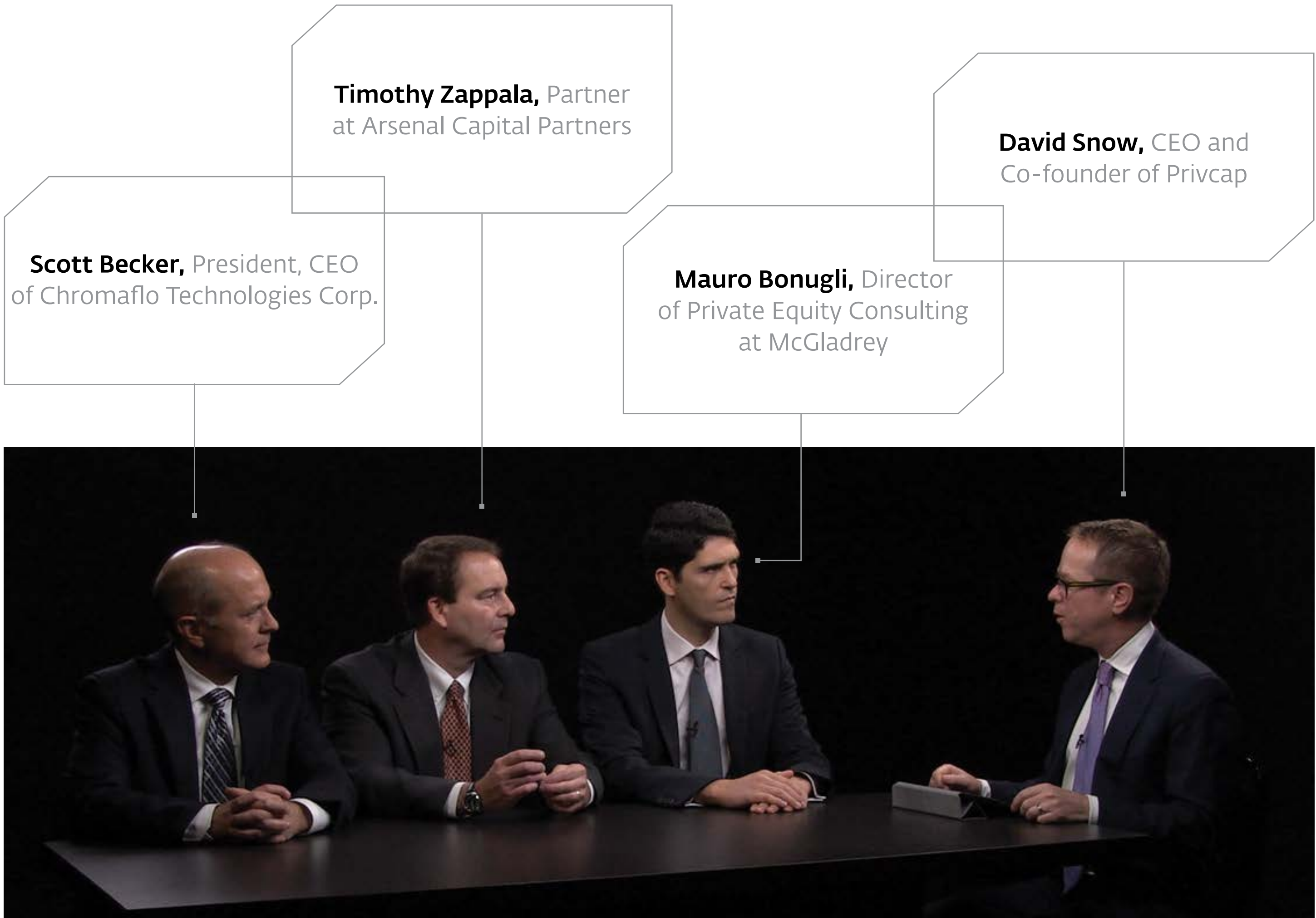
The latter point is notable. Owners of growth companies have tons of options, and there is an ocean of capital that wants to own and partner with them. And the highest bidder does not always win, unlike (most) deals in the public markets. So if you, as a lawyer, cannot provide an extra edge for your client in terms of market knowledge, personal chemistry, and contacts in the contest to woo entrepreneurs and the project of building companies with them, at best you are fungible and at worst you are a millstone around their necks.

Jon Herzog, a partner in Goodwin Procter's Private Equity Group, focuses his practice on company and investor-side merger and acquisition transactions, growth and venture capital investments, and the representation of both emerging and mature private companies, with a sub focus on search fund deals.

GOODWIN PROCTER

Herzog functions best while competing and collaborating with some of the smartest minds in the industry.

"What makes my practice so rewarding is the ability to build strong relationships with clients, who are some of the brightest people I've ever met," he says. ■



Anatomy of a PE Deal

A look inside how Arsenal Capital Partners came to invest in Chromaflo Technologies, and how this deal compares to other formats for adding value in a private equity investment

Good chemistry brings a good result

Most of the time, private equity firms target companies for investment. But sometimes it happens the other way around. Companies—or the people running them—go in search of a PE partner with the skills and knowledge to take them to the next level.

That's what Scott Becker, chief executive officer of Chromaflo Technologies, did. Several years ago he was CEO of Ohio-based pigment-dispersions company Plasticolors when he identified an opportunity to take his business global. But he needed the right partner to make it happen.

"I had found an opportunity within a large German company to carve out a piece of their business that would fit very well with ours, and at that point I realized I needed to get some financial support to

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effect the transaction," Becker says.

Not any investor would do, however. He knew he needed a private equity firm with deep expertise in his industry to execute his plan successfully. He went through 20 firms before deciding on Arsenal Capital Partners, which focuses on small to midsize companies in two areas: chemicals and materials, and healthcare.

"Our practice is very deep and very technically oriented," says Timothy Zappala, a partner at Arsenal. "We also do a lot of carve-outs from corporate parents. Those situations tend to be relatively complex, and therefore our core team is all full-time industry professionals."

Those on Arsenal's chemicals and materials team all have technical degrees, mostly in chemical engineering, and all have run companies or large divisions. Most have done deals in the formulated–materials industry.

"That allows us to be much more supportive as we develop operating plans for companies and help them develop their processes, because our goal is to take smaller entities and scale to larger operating platforms," Zappala says.

In the case of Chromaflo, Arsenal did just that. It concurrently acquired Becker's Plasticolors and Colortrend, the German carve-out that Becker had been eyeing, and merged the two companies to create Chromaflo, with Becker as CEO. Chromaflo is now a global leader in the pigment–dispersions field.

Focused operating teams are key

The collaboration between Arsenal and Becker exemplifies a trend in private equity: firms deploying operating partners not only to take over a company once it's acquired, but to work with company managers and apply sector expertise to evaluate opportunities before a deal is done.

"That's becoming more and more common nowadays," says Mauro Bonugli, director of private equity consulting at McGladrey. "Look at Arsenal, for example, which is very focused on a few sectors. They bring a lot of expertise in those sectors. Pre-investment, they always get involved in the deals. Obviously if you have the industry and the sector expertise, it brings a lot to the table in terms of understanding what the risks and opportunities are in that investment."

A lot of PE firms have functional expertise in-house and hire consultants to provide sector expertise as needed.

Arsenal has built in-house operating teams that are aligned to the firm's sector focus. This approach works for two reasons. "One, we're dealing with small to midsize companies, so they tend to be a little less mature, and we need that leadership experience in order to interface," Zappala says. "Two, as we craft strategies, we find it's more beneficial if we can understand the technology around the companies. So we go very deep. We tend to stay within our area, and that combination allows us to put together much better growth strategies and interface with companies more easily."

Success can be planned for before the close

The 100-day plan is crucial to any private equity deal. It's the road map to value capture that must be executed in the first 100 days after the close. Arsenal typically draws up a 90-day plan and puts it to work before a deal closes, not after.

"Prior to closing, once we have a fix on exactly what our overall strategy is going to be, and when we've dialogued enough with the portfolio company so we know where we want to get alignment, we put together a 90-day plan that has all the commercial aspects, technical aspects that the company will be focusing on, and a variety of various integration-related activities," Zappala says.

PE firms look at different metrics

PE firms draw up their own plans in various ways. Bonugli says he's seen firms with 100-day plans that are somewhat generic, put together based on an investment thesis—such as doubling earnings in five years—and emphasizing what must be done in the first 100 days to get there. And he's seen plans enacted after a close that emphasize very specific lists of strategic initiatives that must be accomplished.

"A lot of private equity funds now look at forward-looking, more operational metrics to figure out what the four or five metrics are that really matter in this business and whether they can figure out, in the fi rst 100 days, how to extract [those metrics] on a recurring basis," says Bonugli.

The right tools build growth

Becker and the Arsenal team identified a number of different priorities in their plan for Chromaflo that they knew must be implemented to drive growth.

Priority one was transferring the technology they had in the U.S. to the global platform that they had developed through their acquisitions. Priority two was to ensure alignment among the diverse cultures brought together in those acquisitions to guarantee that all the cultures were focused on the most important aspect of the new company, which was (and is) customers and potential customers.

Becker made these goals reality by accessing the Arsenal toolbox. "I often reached out to Arsenal," he says. "I continue to reach out to Arsenal to this day, heavily with Tim [Zappala] because he has extensive experience. There isn't a template that exists, but, more or less, experience and advice are critical to making things happen." ■

Leaders from shale development company PennEnergy Resources and its backer EnCap Investments tell Privcap about how they partnered to build a business

Drilling Down into Energy Partnerships

Richard Weber was president and CEO of Atlas Energy until the oil and gas company was sold to Chevron in 2011. Prior to joining Atlas in 2006, he worked at McDonald & Company Securities for 14 years. He has also worked for First Chicago Venture Capital and NBD Bancorp. He received a degree from Ohio's Miami University and an MBA from Tulane University.

Jason DeLorenzo joined the firm in 1999, after spending four years in ING Barings' corporate finance business, specializing in the energy sector. He previously worked as an associate at Wells Fargo Bank's energy group. He received a degree from the University of Texas at Austin.

Privcap: We're here to learn about the relationship that exists between private equity firms and the energy operating companies they invest in. Rich, can you tell us about the relationship between PennEnergy and EnCap?

Richard Weber, PennEnergy Resources: EnCap is our lead equity sponsor. It really has provided the financial backing that allows our company to exist. We're a company focused primarily in the Marcellus shale opportunity in Pennsylvania, as well as the Upper Devonian shale opportunities and, to a lesser extent, the Utica.

And it's roughly a $300M commitment?

Jason DeLorenzo, EnCap Investments: That's accurate. Rich and I go back to 1996. We watched his leadership of the company and the team he assembled in that play and the success they had. EnCap looks for guys who have a lot of industry experience, a lot of great

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relationships in the industry where they can put together a comprehensive team that covers all the disciplines from the engineering, geology, land, finance side, and put together a comprehensive team and business plan that we believe will succeed over the long term.

Rich, can you talk a bit more about why private equity made sense as a partner, and why EnCap?

Weber: Private equity is long-term focused, and when you're starting a company, you need to have a plan, a vision. My partner and I said there's still room for us to build another company, particularly in the Marcellus shale, and we started thinking about who we would partner with. I heard from EnCap quickly. We talked to several other big private equity providers, and we had some criteria. Size mattered. It's more than just the money-we also wanted people that shared our same values.

How important is the plan and the target assets when a proposal is presented to your firm? How much time do you spend looking at the land and even the science behind the plan to get the energy turned into cash flow?

DeLorenzo: We're trying to be in a top-tier economic area. In today's world, on the gas side, that's the Marcellus and the Utica shale. PennEnergy is trying to create an opportunity set that one day somebody larger—a public company, usually—will want to buy. Or alternatively, we could take the company public. So in order to achieve those goals, you need to be in an area that produces top economic returns, regardless of the commodity price cycle.

Can you talk about how the capital initially gets deployed, and the communications that both of you have as you decide to deploy further capital?

DeLorenzo: The $300M commitment initially went towards covering overhead and building up the staff of the company to succeed in the future while they went out and found transactions to acquire and/or lease. So as they come to the board, and as they have opportunities to deploy capital that fits with the business plan we've all agreed on, we advance the capital.

PennEnergy came up with a pretty sizable transaction in the first year. So we went out and acquired some land, and it was roughly a $100M transaction. We're still in a position where we have a lot of capital left on the $300M commitment to support a drilling program.

"PennEnergy is trying to create an opportunity set that one day somebody larger—a public company, usually—will want to buy. Or alternatively, we could take the company public."

Jason DeLorenzo, EnCap Investments

"It's our desire to have an asset that is fairly substantial in scale but where we have de-risked and essentially proven the acreage from a development standpoint."

Richard Weber, PennEnergy Resources

Rich, can you talk about the kind of communication that takes place between you and EnCap as you're building your business?

Weber: We try to be as transparent as possible with what's going on with the business, where we're planning to take the business. We believe that transparency ensures we get the best advice and coaching from the guys at EnCap, and we set up expectations so there's an anticipation of how we're building the business. We have formal board meetings, but there are many more conversations in person and over the phone.

And what are some of the key metrics?

DeLorenzo: You buy something and have a pre-drill estimate of what the rates of return will look like—in other words, what it'll cost to drill a well, what kind of reserves will come out of the ground, and what kind of cash flow it will generate. Then, as we drill wells and see the actual performance versus the pre-drill estimate, we make decisions to potentially deploy more capital. Alternatively, there are situations where the rates of return or the drilling program present some challenges. In those instances, which we have not had at PennEnergy, you try to bring in a partner; you try to bring in some alternative source of capital to diversify risk. You deploy capital elsewhere in a known area.

Where's PennEnergy as a project now? What percentage of the capital has been deployed, and are there any big milestones that are coming up?

Weber: We're well along the way towards a successful enterprise. We've acquired about 70,000 net acres and turned in two wells, but drilled 10 additional wells that will be turned in shortly. We're moving towards our execution phase in terms of development. It's our desire to have an asset that is fairly substantial in scale but where we have de-risked and essentially proven the acreage from a development standpoint and, importantly, built the infrastructure to allow a buyer of a company to accelerate development, which is important in getting value. ■

The Transformation of U.S. Energy Investing

The U.S. energy market has changed for private equity, and for the country as a whole, since 2008. **Robb Turner**, CEO of ArcLight Capital Partners, explains why.

Privcap: How profoundly has the U.S. energy space has changed, both in our economy and around the world.

Robb Turner, ArcLight: From 2005 to 2008 the U.S. had 10M barrels a day of oil production. Over 20 years, production declined about 5M, and the only thing stabilizing it at 5M was offshore Gulf [of Mexico production]. We thought we needed to import natural gas; people thought we had 15 years of supply left. Then another American entrepreneurial miracle happened called long horizontal drilling, or multi-stage fracking, and it unleashed base hydrocarbons across the U.S. Oil production today is 9M barrels, up from 5M. Natural gas is 65 BCF [billion cubic feet] a day, up from the high 50s. And it's changed the geopolitical environment.

Can you walk us through the important differences between America's new bounty of oil versus natural gas?

Turner: As U.S. production went from 10M [barrels] to 5M [barrels], we reconfigured our oil infrastructure to accommodate imported oil. So the oil infrastructure was built around ports. Before this revolution, we got about 30 percent of natural gas out of the Gulf of Mexico and parts of Texas. Today, oil is coming from different parts of the country with big refining areas. And the biggest new gas finds in the U.S. are in the Northeast, so that entire infrastructure needs to be built.

What parts of the landscape will change for this infrastructure to be built?

Turner: For the export of natural gas and natural gas liquids, there's $120B of construction from Corpus Christi through Louisiana. We're also seeing about $50B of construction in Texas, Louisiana, and Pennsylvania—for the chemical industry.

Part of the reason we haven't started exporting oil is because it's illegal in the United States. We are starting to export a little bit of condensate, but by law you have to refine those products and then export. So right now, the way we export our oil finds is by refining our condensate.

> "The biggest new gas finds in the U.S. are in the Northeast, so that entire infrastructure needs to be built."
> — Robb Turner, ArcLight

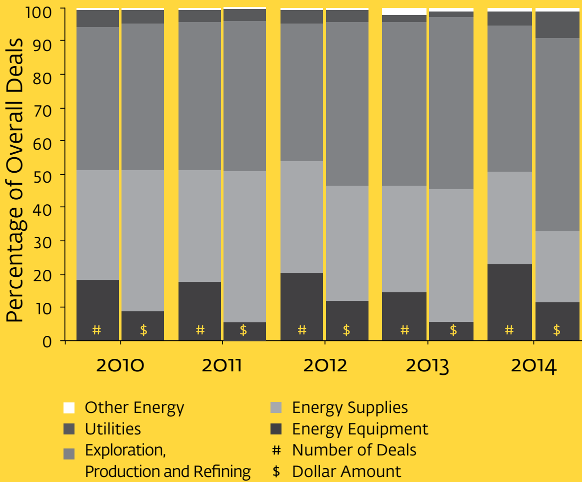
When you started ArcLight in 2000, there was another disruptive technology that everyone was talking about: the Internet. What was it like to try to raise a PE fund focused on industrial objects when everyone was excited about something else?

Turner: Everybody wanted to do media, telecom, Internet. So my partner, Dan [Revers], and I were in the middle of the energy business, and it wasn't the sexiest place to be. But there was a revolution going on back then, starting with the deregulation of the power business, and then it bled over into the E&P business, spinning out what we call our midstream assets.

When we went to start raising the fund, Enron went bankrupt, so then the whole industry gets tarnished. But we believed if we could find 30 investors who understood what we were trying to do, we would make people good money, and fortunately we did. ■

PE-backed E&P, Equipment Deals Jump

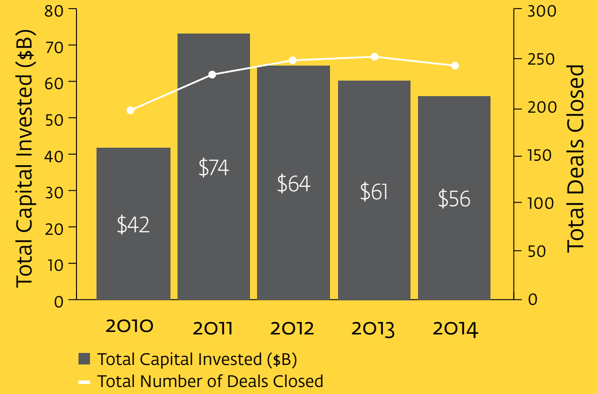
The number of energy deals has remained remarkably constant in the past five years, with the number in the subsector of exploration, production and refining spiking in 2013 and energy equipment transactions jumping in 2014. By dollar amount, E&P deals have taken a huge chunk of capital, while energy services has decreased.



DEALS

PE-backed Energy Deals on the Decline

Overall, the dollar amount of PE-backed energy deals in the U.S. has been on a slow decline since 2011, although the number of deals peaked in 2013 before dropping in 2014.

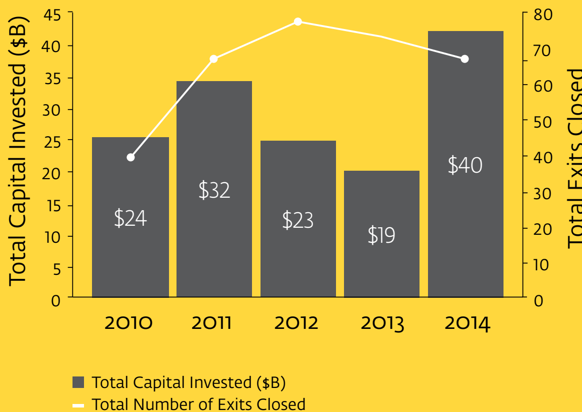


U.S. Energy Exits By PE Grow in Popularity

Private equity-backed energy deals have been on the decline in recent years, while the total number of exits closed exploded in 2014. One subsector in particular saw a huge increase in exits.

A Spike in PE Exits from Energy

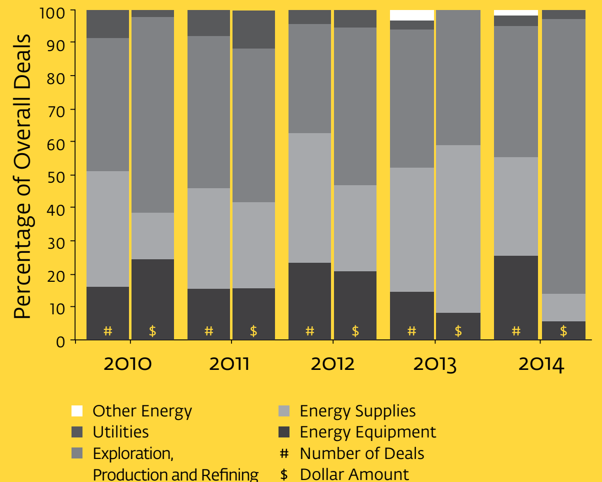
The total dollar amount of capital exited by private equity in the energy sector was dropping sharply since 2011, but then nearly doubled from about $19B in 2013 to about $40B in 2014, although the number of exits closed declined.



EXITS

PE Rushes to Exit E&P Companies

There was a rush to exit companies in the exploration, production and refining category in 2014, taking up roughly 85 percent of the total dollar amount of transactions. By number of exits, the subsector actually saw a drop from 2013, with energy equipment taking up a larger chunk of the transactions.



Source of all charts: PitchBook

Energy's Deal Standoff

As private equity firms and energy companies wait to see where oil prices land, deals are mostly in a holding pattern, says Grant Thornton's Sal Fira

Sal Fira is a partner and practice leader in the Transaction Advisory Services for the Texhoma market territory at Grant Thornton

Grant Thornton
An instinct for growth™

"Some of the energy GPs are salivating, the EnCaps and NGPs. This is what they were founded on. This is where they make their money. This is an opportunity."

-Sal Fira, Grant Thornton

The players in the energy market are in a partial standoff with private equity firms and other potential investors as everyone waits to see how oil prices shake out. Sal Fira, a partner and practice leader in Transaction Advisory Services for the Texhoma market territory at Grant Thornton, has been watching how the market for energy deals has reacted to the commodity's recent price volatility.

"What we're seeing is a lot of 'Who's going to balk first?'" says Fira. "It really is in a holding pattern."

The market for mergers and acquisitions in the energy sector has slowed, as expected, beginning in the fourth quarter of 2014. Sellers are waiting to see where oil prices land, and in this kind of environment they aren't willing to part with assets unless they have to. However, the uncertainty is creating a spread that buyers are willing to pay, so they are on the other side, waiting patiently.

In the oilfield services subsector, companies have generally taken price reductions, depending on where they play, says Fira. The companies closer to the oil patch are taking bigger hits, no matter where they are in the services space. "Their margins are going to get squeezed," he says. "The good news is that some had deals and contracts already in place."

Exploration and production companies are getting hit pretty hard, he says. But in this cycle of oil price volatility, they are better capitalized, he adds. "Depending on how well hedged and capitalized they are, some are doing well and increasing acreage."

The first shoe to drop will be the private-equity-backed deals for operators that have been buying huge amounts of acreage, he says. They will be out in the market selling some of that acreage, because they will have more debt to service.

"A lot of PE funds are on the other side, waiting," Fira says. "They think there will be some great buys. That dynamic is fascinating."

Despite the current tentative market for deals, robust M&A is still expected in 2015, although that's heavily reliant on oil prices rising, he says. For service companies, there will be cost reductions on their part and a strategy of combining to survive, creating some opportunistic buys for those looking for deals in the subsector.

"Some of the energy GPs are salivating," Fira says, "The EnCaps and NGPs. This is what they were founded on. This is where they make their money. This is an opportunity."

Those who invested capital in some of the more at-risk subsectors at the beginning of 2014, such as E&P and services, "will be under magnificent pressure," he says.

That being said, Fira's been seeing and hearing from some in the E&P space that they're "absolutely doing fine" and were smart with their money, compared with previous cycles of volatility.

"I don't think we're going to see a complete meltdown like we have before," he says. "There's been better discipline, better protection on the downside." ■

Does the World Need 700 New PE Firms?

Three veterans of the private equity industry explain why capital continues to flow in, creating hundreds of new managers

Privcap: Since the beginning of the Great Recession, the world has added 700 active private equity firms. Does the world need 700 additional private equity firms?

Steven Millner, Gen II Fund Services: The asset class grows because there's demand for the product. And in a yield-depressed environment where pension managers and others need a certain benchmark return, private equity is the one asset class that can really help a portfolio manager meet their investment objectives.

Why wouldn't the world of investors just give all their extra money to Blackstone and just let them manage it all?

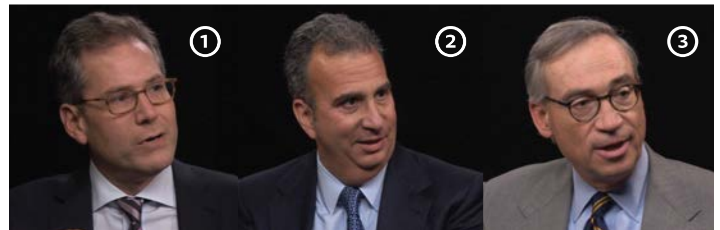
Russell Steenberg, BlackRock Private Equity Partners: Well, Blackstone and KKR certainly have a place in the world. They have defined strategies, and they do various things very well. But that's not to say that you want a concentrated portfolio. Diversification has always been the key in this asset class.

David Wachter, W Capital Partners: Spinout firms that have left larger institutions because they have a passion for a particular niche or an expertise contribute to the 700 number. The industry has to continue to reinvent itself in terms of strategies and geographies and stages of investment. And as more and more of the economy continues to move into private equity hands, it's very logical that new firms and new strategies are developing.

What is the bare minimum number of people needed to start a private equity firm?

Steenberg: There are higher sets of hurdles than you've had in the past because of the world that we're in today, which is why it's harder to start a firm today than it ever has been. Fundraising is part of it; regulation is part of it; so is the fact that limited partners are pruning portfolios and cutting down on the number of general partners that they have. First-time funds are harder to raise today than ever before.

Having said that, three guys with an assistant—if they have the right strategy and they're in the right niche—is the right number.



1 **"As more of the economy continues to move into private equity hands, it's logical that new firms and strategies are developing."**
David Wachter, W Capital Partners

2 **"When we look at our pipeline, it's never been more fulsome with first-time funds than it is right now."**
Steven Millner, Gen II Fund Services

3 **"Diversification has always been the key in this asset class."**
Russell Steenberg, BlackRock Private Equity Partners

Wachter: There's a question as to the definition of what's a private equity firm. There are a lot of new sources of capital moving into private equity that are not in the fund structure anymore. These groups are very hungry and looking to build portfolios of private companies.

Millner There was a compression, there was a dearth of emerging managers for a number of years, and LPs were consolidating their managers. However, when we look at our pipeline, it's never been more fulsome with first-time funds than it is right now. ■

The Mexico Opportunity

There are many reasons to invest in Mexico, say KKR's Vance Serchuk and Henry McVey. But this vast market should be viewed as a long-term investment play.

Privcap: What sectors of the Mexican economy do you find interesting as an investment possibility?

Henry McVey, KKR: On the real estate side, rents are one-third to half [of what they are elsewhere]. And as financial services reform takes place, we think credit will start to flow more in Mexico. You've got great demographics that should continue to shine, and energy reform is a key milestone that would include everything from services and energy to pipelines.

What is unique about the Mexican opportunity that stands in contrast to some other emerging markets?

McVey: With Mexico, you have to look through a different investment lens to capture what the opportunity is. This is a country with a lot of internal demand already; almost 70 percent of the GDP is consumption. Contrast that with China, where it's 36 percent. If you look at GDP per capita, it's $11,000—that's much more than most of the emerging markets. The other thing that's important to highlight is that Mexico is much more likened to America, as well as just North America. As a firm, we have a distinct thesis-that the China manufacturing boom that dominated the 2000 to 2010 period is starting to slow, and we're looking for other ways to play where we think we're going to see incremental growth, either through manufacturing or emerging market growth. And Mexico is clearly in that strike zone.

What are some of the political reforms taking place? What is driving that progress?

Vance Serchuk, KKR Global Institute: Since President Peña Nieto came to office in July 2012, he's been able to engineer a series of historic structural reforms through something called the Pact From Mexico. What we've seen are essentially three major political parties in Mexico coming together on a united program of changes in areas like energy, telecom, fiscal, and governance, though each of these parties represents a different part of the political spectrum. When you think about the world overall, there are not many countries now in either the emerging space or the developed space where you see leadership with the political capital, the political will, and the vision to push through tough structural reforms.

In terms of manufacturing, do recent changes in China, coupled with Mexico's proximity to the U.S., spell a manufacturing opportunity in Mexico?

McVey: Wages in China have been growing somewhere between 9 percent and 11 percent per year. Wages in Mexico have been growing at less than the rate of inflation, so you've had a wild delta where China has exploded to the upside while Mexico has been very flat. Given its proximity to the U.S., Mexico is important. Though if you look at manufacturing, you have to drill down, because there are a couple of things to know. Auto's growth has exploded; exports out of Mexico to the U.S. have quadrupled in the manufacturing sector, and overall, 87 percent of Mexico's manufacturing goes to the U.S. That's the good news. The bad news is that outside of key areas like autos, there haven't been the productivity gains you need. So it's important that Mexico has low-cost wage labor, but ultimately they've got to increase productivity.

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"With Mexico, you have to look through a different investment lens to capture what the opportunity is."

Vance Serchuk, Executive Director, KKR Global Institute

"The key is, you have to understand Mexico for what it is—its own complicated society. Security is a serious issue."

Henry McVey, Member and Head of Global Macro and Asset Allocation, KKR

Does private equity play to the investment opportunity in Mexico? Are there opportunities there to put private capital to work?

McVey: One thing that's most unique about Mexico is that it's dominated by somewhat of a monopolistic or oligopolistic top-down view for most of the industries. Because of these reforms that Vance talked about, you should see some real change where the mid-capitalization stocks will actually start to grow and perform better. Since the president came in, the mid-cap stocks have actually outperformed the large-cap stocks by 50 percent.

Serchuk: This is an extended period where we'll have to see how these reforms play out and what their impact will be. The good news, with respect to the reforms, is that they built up a good head of momentum. The flip side, though, is that the test now falls on implementation and execution, so a number of the reforms still have to get through Congress—so-called implement legislation, energy legislation first among them, but others as well. Then, the next part is how effective the Mexican government will be in being able to carry out, on a day-to-day basis, the new institutions, new regulatory structures, and new laws it wants to put into place.

What is the perception of risk around the violence taking place in Mexico? To what extent is that preventing more investment in the country?

Serchuk: There is a certain schizophrenic quality in the way people talk and think about Mexico. A few years ago, newspaper headlines read that Mexico was going to be the next Afghanistan and that it was on the way to being a failed state. Now you hear the flip side, with a great deal of bullishness about Mexico. The key is, you have to understand Mexico for what it is—its own complicated society. Security is a serious issue. In some respects, security has gotten a bit better, particularly in the last year. Murder rates have gone down. But we see another phenomenon, which is an increase in kidnapping. What's really at stake here is that rule of law in institutions in Mexico remains weak. That means courts, police, and prisons. And while these structural reforms the Peña Nieto government has pushed forward in a variety of other areas are transformational, we have not yet seen the kind of comprehensive strategy that's really credible. ■

Western Canada Focus, Cross-Border Opportunity

TriWest Capital Partners shies away from oil and gas exploration, preferring to focus on companies that service the sector in Canada and across the border

Privcap: Let's start with the focus of your firm, which which is on western Canada. Why the regional focus?

Church: The partners of TriWest are all based in, and have grown up in, western Canada, so that's a market we understand. But it's a very different market. It's energy, forestry, and agriculture. It's got a more industrial, natural–resource spin to it. So we don't have consumer products. We don't have food products. We don't have technology-oriented companies. We felt that over time we have gotten much better at understanding western Canadian companies.

I'm glad you mentioned energy. Talk about how your firm is investing with the oil and gas boom as a backdrop, and how you differ from what folks might expect a Calgary-based firm to focus on.

Church: We don't do oil and gas exploration. There are lots of guys in Calgary smarter than us who know how to do exploration and production. What we focus on is oilfield service and some of the businesses that surround the energy market. And quite frankly, the horizontal, multi-stage fracking that's revolutionized the shale basins in the United States has also happened in Canada and it's changed the dynamic of that marketplace. We're focused on trying to partner with companies that are partners of the industry. We've just invested in a business that is dedicated to getting frack sand into Canada, where frack sand use has just absolutely exploded in the last five years as long horizontal wells with multi-stage fracking have really taken off.

We like to say at TriWest that people aren't exploring for oil anymore, they're producing oil, manufacturing oil, and you want to be part of the manufacturing process. You don't want be part of the exploration process.

> "The partners of TriWest are all based in, and have grown up in, western Canada, so that's a market we understand."
> –Cody Church, TriWest

You mentioned a business that is bringing sand into the Canadian oil and gas market. Can you talk about the importance of creating cross-border growth initiatives for some of your lower-middle-market businesses?

Church: Ten years ago, oilfield service businesses that we might look at would almost be exclusively focused on a particular region in western Canada. Today, the companies we're seeing are almost all cross-border, and that's because that long horizontal multi-stage fracking technology is across the border. We've got three companies, with operations in North Dakota and Saskatchewan, in the Marcellus, and then up in Canada, because the technology and capabilities are transferable, and we love it because it diversifies our risk. So we're in different basins with different exposures, and the cost and netbacks for those plays are different. In a commodity market where you know the oil and gas prices are going to go up and down, you want to be across a number of geographical areas so you're not necessarily betting on one thing.■

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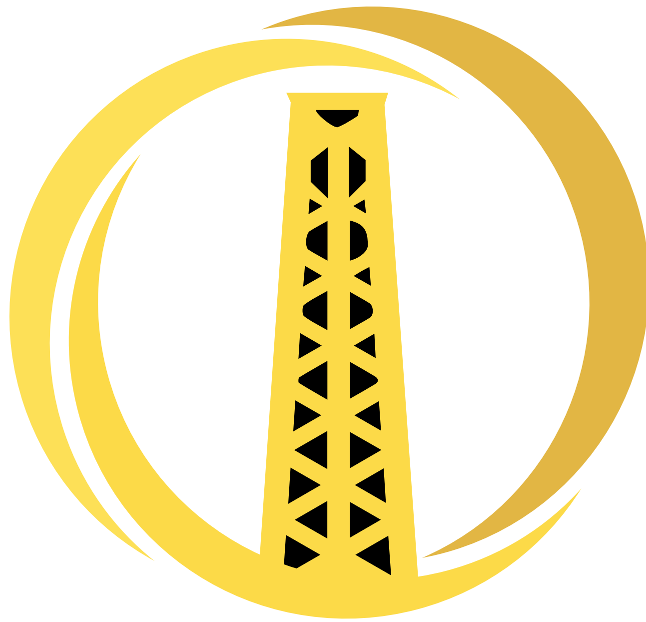

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Case Study: Mold-Masters

Ken Hanau of 3i Group explains how his firm grew, and successfully exited, the maker of plastic injection-molding components

Privcap: How did 3i execute its plan to grow Mold-Masters?

Ken Hanau, 3i Group: Mold-Masters makes a mission-critical component in the plastic injection molding process. It doesn't sound terribly interesting, but [it's] a really great business. And we had the opportunity to partner with a family headquartered just north of Toronto. They were looking for international expansion. There were some key targets for acquisitions in Europe, and they were looking to continue expanding both in China and in India. So in many ways, we thought we were very well positioned with the family to be able to do that, given our strong network in Europe and access to the emerging markets.

Our colleague in Germany, Ulf von Haacke, was very involved from the get-go, and so we had strong connectivity with what we could deliver in Europe, which was critical in winning the deal. And then we went out and embarked on the key part of the strategy, which was international expansion.

"We made 2.7x our money on that investment, with a very good IRR. We're thinking about an exit even before we close on the transaction."

- Ken Hanau, 3i Group

So over the first few years, we brought in several of our distributors through acquisition in Europe. We also made a key acquisition in the U.K. that was a really important product-line extension for the business, strategically. As far as the emerging markets, the company had begun to migrate some of its engineering capabilities to India. We continued that journey, and then we actually opened a manufacturing facility in India to be able to take advantage of that market.

The key part of the success of Mold-Masters was China. To the [founding] family's great credit, they had greenfielded in China right before we made the investment, but it was early days. And over our five and a half years, after buying the business in 2007, we aggressively invested in China, even through the downturn. And so we invested close to $20M during our investment period, trying to drive growth in China, and tripled the size of the manufacturing facility over that period of time.

How did you plan for an exit?

Hanau: We made 2.7x our money on that investment, with a very good IRR. We're thinking about an exit even before we close on the transaction. How do we shape this business into something that strategic [buyers] would be interested in? Who might be the obvious strategics? And then throughout the course of that investment, we're thinking about an exit. As we get closer to exiting—within that 12-month period—we have a very disciplined approach to thinking about what needs to be done to position the business in the most favorable way, and thinking about who, ideally, those strategics are that will be interested.

In every business, there's going to be some complicated aspects that we want to be able to explain very clearly. So we spend a tremendous amount of time thinking, "How do we bring clarity to those numbers in a way that it tells a compelling story but also makes it easy for buyers?" There's a range of other things that we were doing to get this business ready for sale, and I would say that we, as a firm, have done a very good job, and now have numerous examples of being incredibly disciplined about our process well in advance of that exit. ■

Company Valuations: Never an Exact Science

Valuation professionals use several methods and approaches to determine the value of a company, and every transaction is unique, says Weaver's Brian Reed

One of the biggest challenges faced by investors and business owners when buying and selling a company is arriving at the proper valuation for the asset.

While there are several proven approaches and methods used to assess value, no two transactions are ever the same. That's when a seasoned valuation professional proves invaluable.

"The process of determining the appropriate valuation approaches to use in deriving an indicated value of a company generally takes considerable time and experience," says Brian Reed, partner-in-charge of transaction advisory services for Weaver, the largest independent accounting firm in the Southwest and a top-40 firm in the U.S.

When it comes to a market approach to valuation, an analyst may value a company using transactions of similar companies, or "market comps," that occurred in the relevant industry.

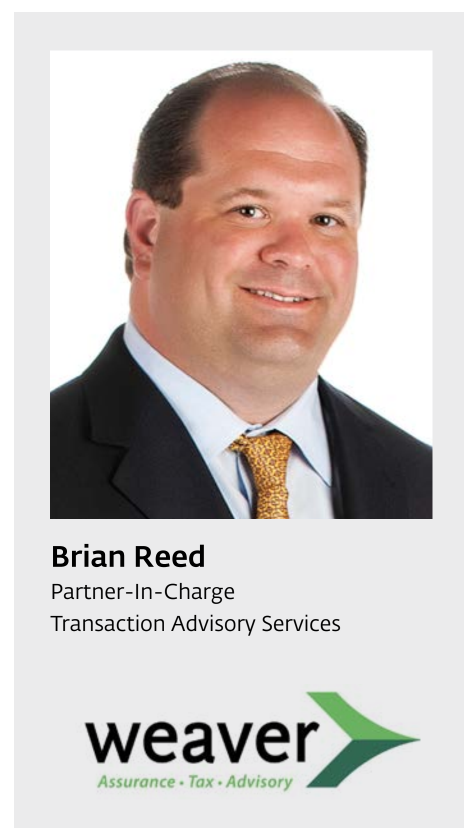
"Specifically, an analyst may utilize the enterprise-value-to-EBITDA multiple observed in a number of transactions to derive an indicated value for the company," he says, adding that, based on these multiples, the valuation analyst would estimate an overall value of the company by applying the selected multiple to the company's EBITDA.

One of the most common difficulties in valuing companies with complex capital structures relates to the rights associated with preferred stock and common stock, and how the value is allocated among relevant shareholders.

"The rights associated with preferred shares, for instance, can be categorized as either economic rights or control rights," he says. The economic rights generally include the following: liquidation preferences, cumulative preferred dividends, mandatory redemption and conversion features. All of these rights could have an impact on the valuation method used and how the value is allocated between preferred and common shares.

While the probability-weighted-expected-return method, the option-pricing method, and the current-value method are all effective in allocating a company's value to the various classes of ownership interests, the most straightforward approach is the current-value method.

"It is the easiest method to understand," says Reed. However, he adds that the *AICPA Accounting and Valuation Guide-Valuation of Privately-Held-Company Equity Securities Issued as Compensation* says its usefulness is limited primarily to two circumstances: (1) when a liquidity event (an acquisition or dissolution) is imminent and expectations about the company's future as a going concern are not relevant, or (2) when the company is in an early stage of development where no material progress has been made on the company's business plan, no significant value has been created for the common equity holders, and there is no reasonable way to estimate the timing or amount of common equity value that may be created in the future.



Brian Reed
Partner-In-Charge
Transaction Advisory Services

With greater scrutiny from the Securities and Exchange Commission on how companies are arriving at their asset values, owners are increasingly turning to third-party experts in order to provide more transparent valuations. ■

Leverage is Easy, Deals are Hard

Debt availability for private equity investments remains robust, but market experts are worried about finding quality deals

Leading participants and analysts expect lending to middle-market private equity deals to remain robust in 2015—and that's a good thing.

Private equity funds are sitting on record levels of dry powder, with middle-market funds a particular favorite of institutional investors, so sponsors will need ample financing in order to get deals done this year. The challenge for private equity sponsors will be finding enough deals at sufficiently attractive returns. After a long period of low interest rates, most potential balance sheet recapitalizations and dividend refinancings have been completed, and sponsors are now seeking loans for mergers and acquisitions or buyout deals.

"There are a lot of lenders looking to put capital to work," says Robert Horak, managing director and co-head of the Debt Advisory Group at Lincoln International LLC, which works primarily with middle-market private equity groups to arrange financing from all lender types. Pension funds, endowments, and other institutional investors have "figured out that middle-market lending is a good asset class to invest in," he says. "They've seen it perform during the downturn, and they've embraced the asset class." He notes that it provides capital through traditional mezzanine funds and other avenues, such as credit opportunity funds, that invest across the balance sheet.

Private equity sponsors are already sitting on $151B in capital targeted at small-to-midmarket opportunities after adding $54B during 2014, according to Preqin. More capital is on the way. Middle-market investing is the most popular PE strategy by a wide margin, with 54 percent of institutional investors in Preqin's 2015 PE Outlook planning commitments to middle-market funds over the next 12 months. The forward calendar for leveraged loans highlights the shift in transaction types within the sector. At the end

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"Interest rates remain at or near historic low levels, making leverage inexpensive."

–Derek Lewis, Harris Williams & Co.

"Deal multiples continue to be very competitive, with leverage and purchase price multiples near 2006-'07 levels."

–Brad Charchut, Sankaty Advisors

of 2014, the pipeline stood at $33B—with $31.4B earmarked for M&A-related loans, according S&P Capital IQ's Leveraged Commentary & Data (LCD) service.

"Interest rates remain at or near historic low levels, making leverage inexpensive," says Derek Lewis, managing director at Harris Williams & Co. That means sponsors can find financing, but it's getting harder to find deals. "There are not enough quality companies coming to market to satiate the demand," he says. That's pushed leverage multiples on middle-market transactions steadily higher. Heading into 2015, LCD says total leverage is averaging 4.8x among loans to issuers generating up to $50M of EBITDA, down from 5x for the third quarter of 2014 and a record 5.2x in the second quarter. Senior multiples are down for the same set of loans, according to LCD.

While the outlook for 2015 is uncertain, participants expect leverage multiples to remain near current levels as lenders backed by rising institutional demand for middle-market strategies offset a pullback by business-development companies and banks, as well as lender caution about financial stress on borrowers in the oil and gas industry.

"Deal multiples continue to be very competitive, with leverage and purchase price multiples near 2006-2007 levels," says Brad Charchut, executive vice president responsible for PE sponsor coverage at Sankaty Advisors, a Bain Capital debt investment affiliate that oversees about $25B. That being said, he adds that "several global macroeconomic and political issues continue to act as periodic guardrails keeping market terms in check."

Outflows from loan mutual funds have tempered the flow of capital to sponsors, while the volatility of BDC share prices—with several trading at discounts to net asset value—has made it harder to raise new money to fund loans. But given the underlying support for continued U.S. economic growth, he adds, "we expect 2015 deal activity and multiples to remain largely unchanged from current levels."

Terms for loans to today's middle-market PE deals reflect the supply-and-demand dynamic. Until the fourth quarter, middle-market yields largely declined in 2014, according to LCD, with the average yield on 137 unitranche loans totaling $10.4B dipping 20 basis points in the third quarter, to 7.4 percent. For 2014 overall, the average yield on such loans, which combine senior and junior debt, declined by 60 bps. LCD bases its analysis on the portfolios of the four listed BDCs that break out unitranche loans in their reported schedules—Golub Capital, Monroe Capital, THL Credit, and Senior Secured Loan Program, a joint venture between Ares Capital, GE Capital Corp., and GE Global Sponsor Finance LLC.

According to LCD, that's likely the floor for yields. "Middle-market transactions typically take longer to complete—anywhere from two to four months to close—and so the rising rates that snared the broader leveraged loan market this fall have only now started to catch up to current business," according to LCD's middle-market review. Moreover, unitranche lenders such as finance companies and BDCs have funding requirements that would prohibit yields from dropping much lower; BDCs try to achieve dividends of 9 percent or more, while returns for finance companies vary widely, depending on their funding sources and whether the balance sheet is leveraged or unleveraged.

Ultimately, says Lewis, "what drives deal multiples is the combination of company performance and availability of debt and equity capital." Both factors support continued firm multiples, he adds, with corporate profits as a percentage of GDP at or near all-time highs, leaving approximately $1.5T of cash on the balance sheets of S&P 500 companies. On top of a record amount of uninvested private equity capital, Lewis says, "that equates to a lot of buying power." And also a big need for financing: While sponsors and lenders must each sharpen their pencils to ensure that terms support adequate IRRs, "we see no shortage of transactions," says Lincoln International's Horak. ■

BAIN'S FOCUS ON Taking Businesses Global

Bain Capital managing director Steve Pagliuca discusses the explosion in global trade and how his firm plans to capitalize on this growth

Privcap: A big theme that you and Bain Capital have focused on is the globalization of business. How do you define this, and can you put it in a historic perspective?

Steve Pagliuca, Bain Capital: Well, if you look to history, in 1700 China and India dominated the world's trade. Half of the GDP of the world was estimated to be those two countries. Then, in the 1850s, the Industrial Revolution came along and left those countries out. So the world GDP became dominated by the U.S. and Europe, which made up half of the total. Today, however, China and India have made a huge comeback over the last 15, 20 years because they've adopted a more capitalist approach. So we project by 2050 we'll be back to where we were in 1700, where GDP is more aligned by population than it is by [an] industrial revolution.

For Bain Capital and several of the firms located in Europe—what turned out to be the large multifaceted private equity firms—that's where we help drive the growth of those businesses, where we spread out in terms of product lines and in terms of investing private equity throughout these countries and using the same model that we use here in the U.S. So that's the interest in global trade. Global trade has really exploded and has helped us to grow.

"You don't invest in countries, you invest in companies. What we pride ourselves on at Bain Capital is that we really understand those companies we've invested in—how they can grow and how to help them grow."

–Steve Pagliuca, Bain Capital

As you look around the world at different geographies and different economies, where do you see the most interesting opportunities that touch on the explosion of international trade?

Pagliuca: We see it everywhere. A company like P&G, which many people would say is an American company, two-thirds of their profits are from overseas today. So everything is globalized. You have to step back and look at the markets and say: The U.S. got out of the crisis. They did a great job with solving the banking crisis quicker than any other country did it. They took the hard medicine, did the quantitative easing, and it brought us back up. Savings are back up, and the banks are probably in as good shape as they've ever been, given the fact that the U.S. moved fast to rapidly restructure it.

If you look at Europe, however, they haven't taken the same approach, and it's very difficult to have an economic union without a global monetary union, so they suffered for that. People would say what they've done is extend many of those bank agreements but not address those fundamental structural issues of those countries. So now you're seeing the situation in Greece, the currency depreciation, and all things as a result of that. So that doesn't mean it's bad to invest in Europe; it may be great to invest in Europe now. But it is a tough situation.

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Bain Capital's Steve Pagliuca and Privcap's David Snow take questions from Privcap Presents attendees

With Asia, growth has slowed down, but it's still growing more than the rest of the world. China still has the 7 to 8 percent growth targets. India, with Prime Minister Modi coming in, has had a resurgence, and Japan's new monetary policies also look good. So Asia's also an interesting area to invest.

We're really micro-economists. We look at every deal on its own merit. So if people say, "Gee, you've got to get your money into Asia," you have to ask, "At what price?" So many folks invested in Asia; they didn't really get out at the right time. What they don't realize is, you don't invest in countries, you invest in companies. What we pride ourselves on at Bain Capital is that we really understand those companies we've invested in—how they can grow and how to help them grow.

One example of one of those companies is Canada Goose. What did you recognize in that company that allowed you to believe that the Bain Capital push would help it grow? And from the other direction, what do you think Canada Goose saw in Bain?

Pagliuca: The entrepreneur [Dani Reiss] at Canada Goose really thought it was a great product and a great opportunity to expand. They originally set out to sell a very small stake in the company, and he got introduced to a couple of our partners within retail throughout the years, and they became very excited about the company's potential.

We did a lot of primary market research. Canada Goose was a small company that occupied a niche, and in our research charts on consumer preferences, the big words that came out were "warmth" and "quality." And we felt there was a large functional segment that would need that warmth and quality, and we really hit it off with Dani Reiss. He's really driving the whole strategy. We're helping him look at distribution, products, and all the kinds of things we can do with primary market research and studies that we did. And so he felt it was a good idea for us to invest in the company, and we formed a partnership. So far, it's going very well. I walked around New York last weekend, and you see these coats everywhere.

Let's switch focus from your market observations to Bain Capital itself, a successful investment business. Why have you and your partners grown it into the large organization that it is today?

Pagliuca: It started way back in 1984. Bain Capital was conceived out of three things, which we've kept to today. One was we were going to do investing in a different way by having larger teams go out and do market research. Then, once we've bought the companies, [we] work directly with those CEOs as an extension of what we had done at Bain & Company. The second thing was, Bain was set up to invest the partners' money into the fund, and so all of us young people who worked there also put everything we had into this fund, and outside investors really liked that. Today we still remain the largest investors in our fund, so we kept that as a core. The third objective of Bain Capital was to create a network, first on the East Coast and then globally, of CEOs, advisers, and government contacts who would benefit the company.

So we think we've created the best integrated global network. In the last 15 years, we have more people than anybody doing strategic consulting. As the world's gotten more specialized and competitive, we now have global, vertical marketing groups. We have TMT's [tech, media, and telecoms], consumer retail, healthcare, industrial, and energy [groups] on a global basis.■

In Search of High-Risk, High-Reward Execs

Recruiting an executive for a distressed portfolio company has a separate set of challenges, says the CEO of JM Search

John Marshall, CEO of JM Search

JM Search
Delivering the Exceptional

If a private equity firm acquires a distressed company or carves out a business from a larger corporation, it needs to put the right executives in place to set the company on the desired path. That's where JM Search comes in.

The firm's CEO, John Marshall, spoke with Privcap about challenges associated with recruiting for distressed companies and corporate carve-outs, where the company does not have a track record of stand-alone success.

Attracting candidates to a distressed company can be difficult because of the perceived risk. Recruiters need a complete understanding of the company and situation in order to determine what candidates are appropriate for the role. Truly understanding the current financial situation, how the company will be capitalized, and its current performance metrics allows recruiters to accurately present information to prospective candidates.

"The type of candidates needed in these situations tend to be more high-risk and high-reward," Marshall says. "That has to be in their DNA."

In a carve-out, the incumbent management team is typically not equipped to operate a stand-alone business. The team members are used to relying on the infrastructure provided by their corporation, so management generally needs to be top-graded. If the management team is viewed as weak, then it is critical to find a leader with experience in building a team that can gain traction in short order.

When recruiting a CEO for one of these special situations within private equity, Marshall says JM Search looks for certain qualities. Ideally, the candidates have been involved in a distressed company or carve-out at some point in their career. JM Search and the private equity firm will assess the person's track record to understand their success in similar circumstances. Often in a distressed situation, there is a strong likelihood that the company will be refinanced, so candidates need experience dealing with the capital markets and must have a strong financial acumen. Additionally, CEOs entering these companies need a high sense of urgency.

"The new CEO must have an extreme bias towards action," Marshall says. "They need to go into the business, assess, and execute in a timely manner."

Private equity GPs also play a significant role in recruiting candidates for distressed companies and carve-outs. Since the makeup of these companies is being drastically changed, candidates often evaluate the opportunity based on the private equity firm's track record.

"It's extremely important that the PE firm is transparent with candidates about the company and situation," says Marshall. "The reputation of the PE firm and how they partner with the executive teams at their portfolio companies are of equal importance." Savvy candidates will do extensive due diligence on the PE firm that is trying to recruit them, Marshall adds.

"Finding the right candidate often comes down to timing," Marshall says. "As a firm, we need to be current on what's happening in the marketplace, so that we know where companies are in the cycle. When a company reaches a successful exit, we need to know their management team and understand which individuals truly impacted the company's success." ■

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